No. 9891

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

PEERLESS STAGES, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Upon Petition to Review a Decision of the United States Board of Tax Appeals.

PETITIONER'S OPENING BRIEF.

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JURISDICTION OF THE COURT.

This is a petition to review a decision of the United States Board of Tax Appeals. The petitioner on review is a California corporation and filed its income-tax return for the calendar year 1936 with the Collector of Internal Revenue for the First District of California at San Francisco, California, and within the judicial circuit of the United States Circuit Court of Appeals for the Ninth Circuit. The respondent on review is the duly appointed, qualified, and acting Commissioner of Internal Revenue of the United States, hereinafter referred to as the Commissioner, holding his office by virtue of the laws of the United States.

The case arose because the Commissioner claimed a deficiency of income tax for the year 1936 in the sum of $25,289.85 and a deficiency in excess-profits taxes for the same year in the sum of $9,609.39. The case regularly came up for hearing before the United States Board of Tax Appeals at San Francisco, California, on October 10th, 1940. Upon the 19th day of December, 1940, the said United States Board of Tax Appeals made its findings of fact and opinion and rendered its decision in favor of the respondent for the full amount of the alleged deficiencies. On the 11th day of March, 1941, and within the time allowed by law therefor, petitioner filed its petition for review by the United States Circuit Court of Appeals, Ninth Circuit, with its assignment of errors.

This Court has jurisdiction upon appeal to review the decision of the United States Board of Tax Appeals in question by virtue of the provisions of paragraphs (a) and (b) of Section 1141 of the Internal Revenue Code.

STATEMENT OF THE CASE.

During the period from 1923 to 1930, inclusive, petitioner operated a motor-bus service between various cities in Northern California (Tr. 42). One of the petitioner's lines ran from Oakland to San Jose, traveling along a thoroughfare known as East Fourteenth Street through the cities of Oakland, San Leandro, and Hayward. The bus line afforded an intercity service but did not offer a purely local passenger service (Tr. 45). The area between Hay-

ward and Oakland contained a good deal of orchard and garden land which was suitable by location and climatic condition for homesites but which had not been developed chiefly because of a lack of an adequate transportation system (Tr. 45).

The petitioner decided to make available a fast, frequent, and economical service between Oakland and Hayward, so that any one who might want to settle in the territory could get to work conveniently, and members of his family could go into Metropolitan Oakland for shopping, schools, and other purposes (Tr. 46).

In planning the extension of petitioner's bus route, its board of directors considered two plans (Tr. 46, 76). One is referred to as the "skeleton service." This would have consisted of running just enough busses to take care of the existing passenger demand and would have resulted in little or no loss to the company. The other plan is referred to as the "extra frequency service." Petitioner's board of directors discussed the feasibility of both plans and decided that the extra frequency service would produce development of the new territory in a faster period of time with a greater ultimate profit, and the board was willing to incur an actual operating loss in the earlier stages of the development in order to accomplish this result (Tr. 75).

Those in charge of the management of the petitioner realized that because of the sparsely settled neighborhood a complete, frequent service could not pay the cost of operating until the neighborhood should develop. It was feasible to offer a local scervice of a

skeleton nature which could operate without loss. However, the company felt that by installing a service that would be in advance of the actual needs of the persons then living in the area, the settlement of the community would be hastened and additional customers would be attracted to the neighborhood (Tr. 76).

In 1931 the company inaugurated a local service; that is, busses originated or terminated in Hayward and Oakland. This operation was entirely separate and distinct from the previous intercity operation. Different busses were used and were run at a twenty-minute frequency. The busses would stop at all corners to pick up and discharge passengers (Tr. 46, 47).

The belief of the officials of the company that the operation of a frequent service at a loss would soon result in the development of new business was justified by the records of the years 1931, 1932, and 1933. The petitioner's records show the following figures for the new route (Tr. 48):

Year	Miles Traveled	Passenger and Express Receipts	Loss from Operation
1931	282,127	$48,356.91	$15,613.54
1932	328,860	58,230.04	11,230.94
1933	342,513	63,355.05	516.47

(Tr. 53, 56, 58; Exhibits 2, 3, 4.)

It appears without contradiction from the record that development and settlement of the area served proceeded very rapidly after the institution of the local bus service (Tr. 48).

In 1933 the company made a survey of adjacent territory which might likewise be developed for local

bus service. San Lorenzo and adjacent territory lay to the south of East Fourteenth Street, while Castro Valley and adjacent territory lay to the north of East Fourteenth Street. During the latter part of 1933, petitioner filed an application with the California State Railroad Commission for authority to extend its local bus service to the San Lorenzo and the Castro Valley area. A permit was received, and in 1934 petitioner instituted an additional local service between Oakland and Hayward by way of Castro Valley and San Lorenzo. This service was likewise operated on a twenty-minute frequency and was coordinated with the existing local service along the East Fourteenth Street route so that along that route the result was a ten-minute headway between Oakland and Hayward (Tr. 48, 49, 50).

The company's officials expected to sustain a loss in the early operation of this new bus route, but believed that the bus route would develop the territory to such an extent that it would ultimately prove a profitable investment (Tr. 75).

The miles traveled, the passenger and express receipts, and the losses for the years 1934 and 1935 are as follows:

Year	Miles Traveled	Passenger and Express Receipts	Loss from Operation
1934	753,967	$101,640.22	$39,459.22
1935	839,046	108,550.72	52,885.41

These figures pertain exclusively to the new routes and have nothing to do with the intercity bus service which the company had been conducting for many years (Tr. 96).

Petitioner's income-tax returns for the years 1931, 1932, 1933, and 1934 deducted the losses sustained from the operations above described as business losses. Mr. George J. Weiser, petitioner's auditor, testified that he prepared and filed the returns for those years without any special thought or discussion of the matter of their being capital investments or ordinary expenses. In the latter part of 1935, the directors of the company were discussing the possibility of a sale of the local bus routes with which we are here concerned. The question of tax liability was discussed, and Mr. Weiser secured expert advice as to the situation. He was advised that in the opinion of these experts, the expenses of development in 1931, 1932, 1933, and 1934 had been incorrectly classified, and they suggested that amended returns be filed (Tr. 71-72). Pursuant to this advice, petitioner filed its return for the year 1935 upon the basis whereby the loss on the local operation was capitalized instead of classified as an ordinary business loss. At the same time, amended returns for the years 1931, 1932, 1933, and 1934 were filed, and the petitioner's tax liability recomputed upon the theory that the sums above stated to be operating losses were capital investments; and additional taxes were paid to and accepted by the Collector of Internal Revenue (Tr. 72).

On January 14, 1936, petitioner entered into a contract of sale with Railway Equipment & Realty Company, Ltd., whereby petitioner sold its local motor-coach lines and operative rights to Railway Equipment & Realty Company, Ltd. The petitioner retained its intercity bus business which it had been

operating prior to the institution of the local bus service. The petitioner reported a gain on the sale of $92,334.74. The Internal Revenue Agent's report declared the gain on the sale to be $212,040.32. The difference of $119,705.58 between the amount reported by the company and the amount found by the Internal Revenue Agent represents the capitalization of the operating losses of petitioner's local routes from 1931 to 1935, inclusive. The facts and figures are not in dispute, and the only question involved is whether petitioner is entitled to capitalize its losses for the five years rather than treat them as ordinary business losses (Tr. 96).

SPECIFICATION OF ERRORS.

The United States Board of Tax Appeals erred in determining the taxable net income of Peerless Stages, Inc., for the calendar year 1931, by failing to allow the taxpayer a cost basis of $119,705.58 for the developed operative rights agreed to be abandoned in that year to the Railway Equipment and Realty Company, Ltd., the $119,705.58 being the sum of the losses incurred by taxpayer in developing a new territory in contemplation of creating a valuable and developed operative right by the operation of facilities in advance of the needs of the community, knowing that such losses would be incurred.

ARGUMENT.

I. PETITIONER CONTENDS THAT A MOTOR-BUS COMPANY SHOULD TREAT AS A CAPITAL INVESTMENT, INSTEAD OF ORDINARY BUSINESS LOSSES, ACTUAL OPERATING LOSS INCURRED IN EXTENDING ITS SERVICE TO NEW TERRITORY, WHERE SUCH SERVICE IS KNOWN TO EXCEED THE IMMEDIATE REQUIREMENTS OF THE COMMUNITIES SERVED AND WHERE SUCH SERVICE IS UNDERTAKEN WITH THE KNOWLEDGE IN ADVANCE THAT IT WILL OPERATE AT A LOSS FOR A CONSIDERABLE PERIOD OF TIME BUT WHERE SUCH SERVICE IS EXPECTED TO FOSTER THE DEVELOPMENT OF THE NEW TERRITORY COVERED AND THEREBY DEVELOP A PROFITABLE BUS ROUTE IN A SHORTER PERIOD OF TIME THAN WOULD HAVE BEEN THE CASE IF AN INFREQUENT SERVICE HAD BEEN INSTITUTED AT A POSSIBLE PROFIT.

The Circuit Court of Appeals, Fourth Circuit, in the case of *Houston Natural Gas Corporation v. Commissioner of Internal Revenue,* 90 Fed. (2d) 814, 19 A.F.T.R. 932, in referring to a public utility entering a comparatively new field where it had not been able to do much business before, said, at p. 817:

> "But an intensive campaign to get new customers at any time gives rise to capital expenditures and the time when such expenditures might be incurred is not confined to the early or formative stages of a company * * *"

In the case now before the Court, the petitioner was incorporated in 1923 and engaged in the business of operating a bus line between Oakland, San Jose, and Santa Cruz, California, and between Oakland and Palo Alto, California, until late in 1931 (Tr. 42).

Just prior to 1931 the company prepared a survey of the territory surrounding San Leandro and Hayward and decided to expand their operations by put-

ting in a local bus service between Oakland, San Leandro, and Hayward. The area was largely open land, but climatic conditions were ideal, and it appeared to the company that inasmuch as lots and homesites could be purchased here for a very small amount and were close to the City of Oakland, this territory should develop into quite a homesite area. Development had been hampered by a lack of adequate transportation facilities. The company decided to make available a fast, frequent, and economical service between Oakland and Hayward in order to encourage the development (Tr. 46). A skeleton service would have delayed the development of the area. A high-frequency service was therefore put on in 1931, being entirely distinct from the intercity busses which continued operation to San Jose by way of San Leandro and Hayward and in addition thereto. The new busses ran at a twenty-minute frequency (Tr. 46, 47).

The directors of petitioner at the time they entered into the new local service realized that the twenty-minute-frequency service instead of the skeleton service would have to be operated at a loss for several years (Tr. 73, 74, 70).

During the year 1931, 282,000 miles of service were rendered by the new service of local busses between Oakland and Hayward. The receipts from this service were $48,356.91. During the year 1932, the mileage was increased by 328,860 miles, and the receipts amounted to $58,230.04. In 1933, the mileage was increased to 342,513 miles, and the receipts increased to $63,355.05. This increase in service caused a rapid

development and settlement of the area (Tr. 47, 48). During the first year of development, 1931, the loss from local service was $15,613.54 (Tr. 48). During the year 1932, the loss from the local service amounted to $11,230.94. During the year 1933, the actual loss sustained on the new local line between Oakland and Hayward was only $516.47 (Tr. 96).

During the latter part of 1933 or the early part of 1934, petitioner secured a new certificate authorizing the petitioner to serve the San Lorenzo and Castro Valley areas. The outlying territory of San Lorenzo and Castro Valley was sparsely settled at the time that petitioner instituted local service (Tr. 49, 50). This territory was operated on an approximate twenty-minute frequency. The addition of these busses together with the busses on the Oakland-Hayward development made the East Fourteenth Street to Oakland service on a frequency of about ten minutes (Tr. 50).

The loss in the operation of this frequent service in 1934 was $39,459.22, and in 1935 the loss was $52,885.41. As the loss for the Oakland-Hayward local line had been reduced to $516.47, because of the development of the community after the installation of the service (Tr. 51, 48), a very valuable right and goodwill had been built up on the Oakland-Hayward local route by the end of 1933. These losses were therefore a capital investment and should have been capitalized by the taxpayer.

> *Houston Natural Gas Corp. v. Commissioner of Internal Revenue,* supra, at 816.

The entirely new development which resulted in the losses of 1934 and 1935, known as the San Lorenzo and Castro Valley development, is even more clearly a capital expenditure. This territory had never had any public transportation facilities before the petitioner received its right to enter the territory from the California Railroad Commission and started its development of the territory in 1934 (Tr. 49, 50).

In *Liberty Insurance Bank v. Commissioner of Internal Revenue,* 14 B.T.A. 1428, the Board held that the amounts expended for novelty banks distributed to obtain new depositors were disallowed as a business expense on the ground that the expenditures created benefits extending into future years. The Board said at 1435:

> "In several cases we have pointed out that expenditures for advertising and promotion may create or increase the value of an asset in the nature of a trade name or good will. We have pointed out that in such cases it would be proper to capitalize that portion of such expenditures that can properly be said to be directed toward such an object. *Northwestern Yeast Co.,* 5 B.T.A. 232; *Richmond Hosiery Mills,* 6 B.T.A. 1247; affd. 29 Fed. (2d) 262. The difficulty is a practical one in determining what portion represents a current expense of the business of the year and what portion is properly to be attributed to future years. We are satisfied that in the instant case the usefulness of these banks as an advertisement for the petitioner did not cease with the taxable year."

The Circuit Court of Appeals, Eighth Circuit, in the case of *Meredith Publishing Co. v. Commissioner*

of Internal Revenue, 64 Fed. (2d) 890, 12 A.F.T.R. 467, held that magazine circulation is an intangible capital asset, and money spent in increasing it is a capital expenditure not deductible as an ordinary business expense in determining the publisher's taxable income. The Court, at p. 893, says:

> " 'Circulation structure is an asset which must be continually supported by bringing in new subscriptions to replace those which are continually expiring. Gardner Printing Company Case, supra. The cost of so supporting the circulation structure is an ordinary and necessary business expense but the cost of building up or establishing a circulation structure must be charged to capital.' "

In the case before the Court it is clear that on the two new routes on which the losses were capitalized the bus company was not maintaining its present business status but was knowingly going into new territory which was undeveloped and which would necessarily take a long period of time to develop to a paying status. Petitioner contends that it made an expenditure of a large amount of money to acquire something of permanent use or value in its business. The company acquired many new customers as shown by the increase in its receipts. Territory was built up by people who moved into the community as a result of the company's giving them adequate, frequent transportation. As a result of the higher-frequency service installed by the company, and the development of the community resulting therefrom, the company acquired a large number of new customers, and the petitioner's

right became very valuable, as shown by the fact that the right was purchased in January of 1936 by the Railway Equipment and Realty Co., Ltd., for $212,-040.32. As was said in *Houston Natural Gas Corp. v. Commissioner of Internal Revenue,* supra, at 816:

> "Courts must look to the substance rather than the form of a particular transaction in applying taxing statutes. United States v. Phellis, 257 U.S. 156, 42 S. Ct. 63, 66 L. Ed. 180; McCaskill Co. v. United States, 216 U.S. 504, 30 S. Ct. 386, 54 L. Ed. 590. A large list of satisfied customers on the books of this corporation is not merely an aggregation of disconnected individuals, but is a combination of business with a measurable degree of permanency. Its customers, with service lines completely installed, may be depended upon with some degree of certainty to continue to purchase gas from it in the future. In Gauley Mountain Coal Co. v. Commissioner, supra, this court said: 'Intangible property, which enables a taxpayer to save or earn money, is as legitimate a form of capital investment as tangible property.' Whether it is called good will or something else, is unimportant, so long as it constitutes invested capital."

The early losses or deficits or the amount for which the earnings of the public utility have failed to meet the ordinary operating expenses, will in the majority of cases very closely measure the cost of developing the business.

See *re Lafayette Telephone Co.,* P.U.R. 1920 A 422, where the Indiana Public Service Commission held that the logical and equitable basis for determining the growing value of a public utility is to capitalize

the unrequited losses and the cost of establishing the business.

In *Houston Electric Company v. City of Houston*, 265 Fed. 360 at 362, the Court said:

> "Partly in detail, the development cost embraces preliminary outlays and unrecovered costs in operating the plant itself until a paying business has been established, and subsequently for extensions into sparsely settled territory, until the growth of that particular section affords an adequate return. This cost continues with the continued extension and development of the plant."

In *Hill, et al. v. Antigo Water Co.*, 3 Wis. Ry. Comm. Rep. 623 at 713, the Commission said:

> "As to whether the cost of building up the business should be included in the value of a plant, or gradually charged off from the earnings when these earnings become large enough to warrant it, or rather when they have so increased as to cover operating expenses including depreciation and a reasonable return upon the investment, and, besides this, leave a surplus that may thus be devoted to the wiping out of the cost in question, may not be entirely clear. When added to the original capital upon which interest and profits should be earned, it becomes a permanent charge upon the consumers. This charge, however, is low, as low, in fact, as it very well can be made. When gradually written off, it results in a high annual charge upon the present consumers, but in a charge that will terminate when the cost has been wiped out. Either plan may be feasible. As to which one is preferable is a question that depends upon the circumstances in each particular case.

"When all the facts are considered, however, it will probably be found that in most cases it is better to include these costs in the capital than to attempt to wipe them out in a comparatively brief period through some system of amortization. These costs, as shown, are in the nature of an investment and should therefore, it would seem, be treated as such. They largely belong to the same class of costs as the interest on capital and certain other items for which allowance is made during the construction period. It is true that these costs become a permanent charge when they are included in the capital, and that they are ultimately extinguished when they are written off. But this would not seem to affect the conclusion already stated."

In the case of *W. E. Decker v. Galen H. Welch, Collector,* 15 A.F.T.R. 1027, the Court held that the taxpayer was entitled to have allowed as capital cost, the amounts spent in increasing circulation of a newspaper, notwithstanding that such amounts were returned during the taxable year as expense or cost of operation.

The Board of Tax Appeals has also upheld this doctrine in the case of *S. C. Toof & Co. v. Commissioner of Internal Revenue,* 21 B.T.A. 916 at 939.

In the case before the Board, the petitioner for the year 1935 charged its losses in the amount of $52,-885.41 as a capital expenditure in developing the entirely new lines to the San Lorenzo and Castro Valley territory (Tr. 51).

It is admitted that the taxpayer charged these expenses in developing the new lines and territory for

the years 1931, 1932, 1933, and 1934 as an ordinary business expense. However, it is well settled that a taxpayer is not irrevocably bound by the erroneous treatment of an item affecting his tax liability either in the matter of accounting or in his tax returns.

> *United Profit-Sharing Corp. v. United States,* 66 Ct. Cl. 171, 6 A.F.T.R. 7850.

The Court of Claims in *United Profit-Sharing Corp. v. United States,* 66 Ct. Cl. 171 at 181, 6 A.F.T.R. 7850 at 7855, in holding that where a company spent large sums in acquainting the public with its advantages for two years in order to get new customers, it should capitalize the sums so spent, said:

> "The unusual and extraordinary purpose of the expense had been accomplished. These vast sums of money were expended for the sole purpose of procuring contracts from which plaintiff might derive profit. They were not ordinary expenses. They were, in a proper sense, capital expenditures, and should have been spread over a period of years in determining plaintiff's tax liability."

In the case before this Court the petitioner, knowing it would suffer a loss for a considerable period, put on a high-frequency schedule instead of a skeleton schedule in order to develop the territory and acquire new customers. This was the result of its policy, and a valuable right was developed. It should capitalize the losses incurred in the promotion of the new territory and right.

CONCLUSION.

For the reasons above noted, petitioner respectfully submits that the decision of the United States Board of Tax Appeals that there are deficiencies for 1936 of $25,289.85 in income tax and $9,609.39 in excess-profits tax was erroneous and should be reversed.

Dated, San Francisco,
October 6, 1941.

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